

E-FILED on 8/12/08IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF CALIFORNIA  
SAN JOSE DIVISION12 In re EXTREME NETWORKS, INC.  
13 SHAREHOLDER DERIVATIVE  
14 LITIGATIONNo. C-07-02268 RMW  
ORDER GRANTING NOMINAL  
DEFENDANT'S MOTION TO DISMISS

15 This Document Relates To:

**[Re Docket No. 68]**

16 ALL ACTIONS.

18 Lead plaintiff Frank Grucel brings the present action as a derivative suit on behalf of  
19 Extreme Networks, Inc. ("Extreme") against certain current and former directors and officers of  
20 Extreme. Nominal defendant Extreme moves to dismiss the second amended complaint ("SAC") for  
21 failure to make demand against the company or to plead with particularity that demand should be  
22 excused. Extreme also moves to dismiss on the grounds that lead plaintiff Grucel lacks standing.  
23 Plaintiffs oppose the motion. The court has read the moving and responding papers and considered  
24 the arguments of counsel presented at a hearing on August 8, 2008. For the reasons set forth below,  
25 the court GRANTS Extreme's motion to dismiss.  
26  
27  
28

**I. FACTS**

Lead plaintiff Grucel filed his original complaint on May 31, 2007. The SAC was filed on February 25, 2008. Plaintiffs assert violations of federal securities and state laws against certain current and former directors and officers of Extreme arising from stock option backdating. SAC ¶¶ 1, 2. Specifically, plaintiffs allege that officers and directors of Extreme manipulated the grant dates and associated documentation of stock options used to compensate Extreme employees and directors. *Id.* ¶¶ 6, 9, 12, 14-17. Plaintiffs allege that the various illegal activities occurred between 1999 and 2006, which is the "relevant period" for this lawsuit. *Id.* ¶ 24. Because plaintiffs must demonstrate that making a demand on the board of directors would have been futile (a factually-intensive inquiry), the details of Extreme's corporate structure, history and transactions follow.

**A. Structure of the Board of Directors**

Extreme is a Delaware corporation with its principal executive offices in Santa Clara, California. SAC ¶ 4. Extreme designs ethernet infrastructure solutions for enterprises and service providers. *Id.* Its common stock is listed on the Nasdaq under the stock symbol EXTR. *Id.*

The Extreme board has two committees relevant to this motion. The Compensation Committee "reviews the performance and compensation levels for executive officers and sets salary and bonus levels and option grants under [the] stock option plan." *Id.* ¶ 61; *see also id.* ¶ 62. The Audit Committee reviews and reports to the Board on:

(I) the financial reports and other financial information provided by the Company to any governmental body or to the public, (ii) the Company's systems of internal and external controls regarding finance, accounting, legal compliance and ethics that management and the Board have established and (iii) the Company's auditing, accounting and financial reporting processes in general.

*Id.* ¶ 63.

At the time this suit was filed, Extreme's board of directors consisted of seven members, Mark Canepa and defendants Gordon L. Stitt, W. Michael West, Harry Silverglide, Robert L. Corey, Kenneth Levy and Charles P. Carinalli. *Id.* ¶¶ 29, 201. Stitt co-founded Extreme in 1996 and served as president, CEO and director until August 2006 when he was appointed Chairman of the Board. *Id.* ¶ 39. West served as Chairman of the Board from September 2004 until August 2006. *Id.* ¶ 40. He continued to serve as a director until 2007. *Id.* Silverglide has been a director of Extreme since

1 June 2004 and served on the Audit Committee in 2006. *Id.* ¶¶ 30, 45. Corey joined the board in  
 2 December of 2003, the Compensation Committee in July 2004 and the Audit Committee in 2005.  
 3 *Id.* ¶ 46. Levy has served on the Extreme board since October 2001 and served on the Audit  
 4 Committee in 2005 and the Compensation Committee in 2005 and 2006. *Id.* ¶¶ 30, 47. Carinalli has  
 5 been a director of Extreme since October 1996, served on the Compensation Committee from 1999-  
 6 2007 and served on the Audit Committee from 2001-2007. *Id.* ¶ 48.

7 The committee membership details are summarized in the following table<sup>1</sup>:

	<b>Compensation Committee</b>	<b>Audit Committee</b>
<b>FY98</b>	Carinalli	
<b>FY99</b>	Carinalli	
<b>FY00</b>	Carinalli	Carinalli
<b>FY01</b>	Carinalli	Carinalli
<b>FY02</b>	Carinalli	Carinalli
<b>FY03</b>	Carinalli	Carinalli, Corey
<b>FY04</b>	Carinalli, Corey, Levy	Carinalli, Corey, Levy
<b>FY05</b>	Carinalli, Corey, Levy	Carinalli, Corey, Silverglide

16 *See id.* ¶ 30. Gordon Stitt and Michael West, although both serving on the board of directors, never  
 17 served on either the Compensation or Audit Committee.

18 According to Extreme's certificate of incorporation, Extreme directors are immunized to the  
 19 fullest extent permitted by the Delaware General Corporation Law. Decl. of Joseph E. Floren, Ex.  
 20 12 (June 27, 2008) (reproducing Extreme's certificate of incorporation as part of the Form S-1 filed  
 21 with the SEC).<sup>2</sup> Consequently, the directors cannot be held liable for any breach of fiduciary duty,  
 22 except for breaches of the duty of loyalty, actions involving intentional misconduct or actions taken  
 23 "not in good faith," and transactions from which they derive an improper personal benefit. *See* 8  
 24 Del. C. § 102(b)(7).

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26 <sup>1</sup> Members not pertinent to the court's analysis have been omitted.

27 <sup>2</sup> Public records, such as SEC filings, are properly the subject of judicial notice, and routinely  
 28 considered in deciding a motion to dismiss in a securities case. *See, e.g., In re CNET Networks, Inc.*,  
 483 F. Supp. 2d 947, 953-54 (N.D. Cal. 2007); *In re Copper Mountain Sec. Litig.*, 311 F. Supp. 2d  
 857, 865 (N.D. Cal. 2004); *In re Calpine Sec. Litig.*, 288 F. Supp. 2d 1054, 1076 (N.D. Cal. 2003).

1           **B.     Extreme's Investigation Into Backdating, and Restatement**

2           Concerns about stock option backdating began with the now-famous *Wall Street Journal*  
3 article of March 18, 2006 reporting academic research suggesting that various companies were  
4 suspiciously lucky in selecting their option grant dates. On September 15, 2006, Extreme  
5 announced in a Form 8-K that its directors appointed a special committee of outside companies to  
6 review Extreme's historical practices and accounting for stock option grants. SAC ¶ 183. This  
7 investigation delayed the filing of Extreme's Form 10-K for 2006 and jeopardized Extreme's listing  
8 on Nasdaq. *Id.* ¶¶ 183-189. On January 8, 2007, Extreme announced that it had reached a  
9 preliminary conclusion that the dates of some stock option grants differed from the actual grant  
10 dates. *Id.* ¶ 186. Accordingly, Extreme advised that its past financial statements for the fiscal  
11 periods 2000 through the third quarter of 2006 could not be relied upon and would need to be  
12 restated. *Id.*

13           Extreme released further details of its investigation in its delayed Form 10-K for 2006, filed  
14 on June 28, 2007. *Id.* ¶ 190. The special committee examined option grants from April 9, 1999  
15 through September 30, 2006. *Id.* The review encompassed over 8,000 grants on 346 grant dates.  
16 *Id.* ¶¶ 190, 191. The grant date was incorrect for 72 of the 346 grant dates examined. *Id.* ¶ 191.  
17 While the deficiencies that led to incorrect reporting dates occurred predominantly between 1999  
18 and 2001, they continued to some degree until 2005. *Id.* ¶ 190. The special committee found that  
19 the Board had delegated option granting authority to the CEO for grants of 40,000 shares or less to  
20 employees that were not officers or directors of the company. *Id.* ¶ 191.

21           Extreme issued options to officers, directors or other individuals requiring the Board's  
22 approval on 43 dates within the review period. *Id.* Of those 43 grant actions, 11 used the incorrect  
23 dates, 9 with lower stock prices than the actual dates. *Id.* Although the special committee found no  
24 evidence of fraud, in some cases the incorrect dates appear to have been the result of retrospective  
25 selection based on price considerations. *Id.* ¶¶ 190, 191 (citing Extreme's Form 10-K filed June 28,  
26 2007). Of the affected option grants to Extreme's directors and officers, none were exercised and all  
27 but one grant have been surrendered or cancelled. Decl. of Joseph E. Floren, Ex. 2 at 54 (Extreme's  
28

1 Form 10-K filed June 28, 2007). In response to the special committee report, the board adopted new  
 2 processes to appropriately determine measurement dates. *Id.*

3 **C. Instances of Alleged Backdating**

4 Plaintiffs allege backdating at Extreme for 10 of the 12 publicly reported grants between  
 5 September 1999 and December of 2001. SAC ¶¶ 82-117. While the facts as pleaded would appear  
 6 to be sufficient to allege backdating of these grants, the complaint is rife with factual errors. The  
 7 complaint contains multiple incorrect stock prices. *See id.* ¶¶ 91, 95, 99. Additionally, the  
 8 complaint makes factually incorrect allegations. *See id.* ¶¶ 102, 105, 109. For example, the grant on  
 9 October 22, 2001 was alleged to be "***the lowest share price for that month***" (emphasis in original)  
 10 when it is in fact not in the lowest third of prices for the month. *Id.* ¶¶ 109. While a minority of  
 11 these errors appear to strengthen the allegations of backdating, these defects in the complaint raise  
 12 serious questions as to whether the complaint is well pleaded.

13 Plaintiffs also challenge four option grants between October 2003 and January 2006. *Id.* ¶¶  
 14 120-21. Three of these grants were reported in Form 4s that were filed outside of the two business  
 15 day SEC requirement. *Id.* ¶ 120. The Form 4 for the grant on September 29, 2004 was filed one day  
 16 late. *Id.* The price increase between the filing and the grant date was 9.46%. *See id.* The filing of  
 17 the Form 4 for the January 25, 2006 grant was five days late, resulting in a stock increase of 4%.  
 18 *See id.* Finally, the plaintiffs acknowledge that the June 3, 2004 grant was filed within the two day  
 19 window required by the SEC, but note that it was issued on the lowest price of the month. *Id.* ¶ 121.  
 20 The grants addressed in the complaint are summarized below:

	Exercise Price	Alleged Indicia of Backdating	Defendant Recipients (directors emphasized)
Sept. 17, 1999	\$57.38	The stock price 20 days later was \$87.25 resulting in a return of 52.07%. The grant was not reported in a Form 4 until Jan. 10, 2000. From the Merrill Lynch analysis: the management annualized return was 937%, compared to 88.39% for investors. The grant preceded a "run-up" in the share price.	Hull: 100,000 options.

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1	Dec. 17, 1999	\$66.62	The stock price 20 days later was \$78 resulting in a return of 17.07%. The grant was not reported in a Form 4 until Jan. 26, 2001. From the Merrill Lynch analysis: the management annualized return was 307.5%, compared to 88.39% for investors. The grant preceded a "run-up" in the share price.	Fukuda: 50,000 options. Haddock: 170,000 options. Palermo: 50,000 options. Schneider: 170,000 options. <b>Silverglide:</b> 140,000 options. <b>Stitt:</b> 300,000 options.
6	Jan. 10, 2000	\$76.00	This was the lowest share price for the month and fiscal quarter. The stock price 20 days later was \$93 resulting in a return of 22.37%. The grant was not reported in a Form 4 until July 27, 2000. From the Merrill Lynch analysis: the management annualized return was 402.6%, compared to 88.39% for investors. The grant preceded a "run-up" in the share price.	Halabi: 100,000 options.
12	June 1, 2000	\$49.50	This was the lowest share price for the month. The stock price 20 days later was \$101.12 (reported incorrectly in complaint). The grant was not reported in a Form 4 until July 27, 2000. The grant preceded a "run-up" in the share price.  (As the complaint reported the incorrect stock price, the Merrill Lynch and CFRA analyses cannot be relied upon.)	Halabi: 100,000 options.
18	June 8, 2000	\$75.00	The stock price 20 days later was \$112 (reported incorrectly in complaint). The grant was not reported in a Form 4 until July 27, 2000. The grant preceded a "run-up" in the share price.  (As the complaint reported the incorrect stock price, the Merrill Lynch and CFRA analyses cannot be relied upon.)	Miller: 120,000 options.
24	July 5, 2000	\$94.94 (reported incorrectly in complaint)	The stock price 20 days later was \$134.38 (also reported incorrectly in complaint). The grant was not reported in a Form 4 until June 8, 2001. The grant preceded a "run-up" in the share price.  (As the complaint reported the incorrect stock price, the Merrill Lynch and CFRA analyses cannot be relied upon.)	<b>Stitt:</b> 400,000 options. Haddock: 200,000 options. Schneider: 200,000 options. <b>Silverglide:</b> 200,000 options. Hull: 50,000 options. Palermo: 200,000 options.

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1	April 9, 2001	\$14.57	This was the lowest share price for the month and fiscal quarter. (It was not the lowest share price of the year as reported in the complaint. The entire month of October was lower.) The stock price 20 days later was \$34.65 resulting in a return of 137.82%. The grant was not reported in a Form 4 until July 26, 2001. From the Merrill Lynch analysis: the management annualized return was 2480.7%, compared to 70.83% for investors. The grant preceded a "run-up" in the share price.	<b>Carinalli:</b> 50,000 options. <b>Silverglide:</b> 100,000 options. <b>Stitt:</b> 200,000 options.  Complaint also states that "top executive officers" received "\$600,000 options." It is unclear if this is a scrivener's error or if the plaintiffs are measuring this grant in dollar amount as opposed to number of shares.
9	Oct. 2, 2001	\$6.42	This was the lowest share price for the month and fiscal quarter. (It was also the lowest share price of the year not the second lowest as reported in the complaint.) The grant was reported in a Form 4, 12 days later on Oct. 18, 2001. The stock price 12 days later was \$10.78. The grant preceded a "run-up" in the share price.  (As the grant was reported 12 days later, the use of analyses that rely on 20 day returns is illogical. Consequently, the Merrill Lynch and CFRA are inapplicable.)	Todd: 850,000 options.
16	Oct. 22, 2001	\$10.64	This share price was not in the lowest third of prices for the month. (The complaint erroneously alleges that this was the lowest share price of the month.) <sup>3</sup> The grant was reported in a Form 3, 8 days later on Nov. 1, 2001. (The complaint erroneously alleges that it was reported 10 days later.) The stock price 8 days later was \$11.70. The grant preceded a "run-up" in the share price.  (As the grant was reported 8 days later, the use of analyses that rely on 20 day returns is illogical. Consequently, the Merrill Lynch and CFRA are inapplicable.)	<b>Levy:</b> 100,000 options.

<sup>3</sup> This error was noted and corrected in a letter to the court from plaintiff's counsel filed immediately after the hearing on August 8, 2008.

1	Dec. 28,	\$12.76	This was the second lowest share price for the month. The grant was reported in a Form 4, 8 days later on Jan. 4, 2002. The stock price 8 days later was \$16.55. The grant preceded a "run-up" in the share price.  (As the grant was reported 8 days later, the use of analyses that rely on 20 day returns is illogical. Consequently, the Merrill Lynch and CFRA are inapplicable.)	<b>Stitt:</b> 750,000 options. Schneider: 385,000 options. Haddock: 385,000 options. <b>Carinalli:</b> 137,500 options.
2	Oct. 23, 2003	\$7.07	This was the third lowest share price for the month. The grant was reported in a Form 4, 12 days past the SEC deadline, on Nov. 12, 2003. The stock price when reported was \$9.69.	Unknown
3	June 3, 2004	\$4.97	This was the lowest share price for the month. The grant was reported in a Form 4 within the two day SEC deadline. The stock price when reported was \$5.19.	Unknown
4	Sept. 29, 2004	\$4.44	This was the third lowest share price for the month. The grant was reported in a Form 4, one day past the SEC deadline, on Oct. 4, 2004. The stock price when reported was \$4.86.	Unknown
5	Jan. 25, 2006	\$4.74	The grant was reported in a Form 4, 5 days past the SEC deadline, on Feb. 3, 2006. The stock price when reported was \$4.93.	Unknown

#### D. Procedural History

Lead plaintiff Grucel filed his original complaint on May 31, 2007. On June 8, 2007 Grucel moved to have his case consolidated with two other actions against defendants, and to have himself appointed lead plaintiff. In this motion Grucel asserted that he should be appointed lead plaintiff because "he filed a particularly well-researched and comprehensive complaint" and "has thus demonstrated his intention to aggressively represent the interests of Extreme Networks in this case with energy, enthusiasm and vigor." Mot. to Consolidate Actions and to Appoint Frank A. Grucel, Jr. Lead Pl. and Appoint Lerach Coughlin Stoia Geller Rudman & Robbins LLP Lead Counsel at 8-9 (June 8, 2007).

Plaintiffs Yenna Wu and Linda Erikson did not make a timely opposition to this motion. On July 10, 2007, plaintiffs Wu and Erikson filed a Motion to Consolidate Related Actions and Appoint

1 Lead Plaintiffs and Lead Counsel. Subsequently, on July 31, 2007, Plaintiffs Wu and Erikson filed a  
 2 Notice of Withdrawal of Yenna Wu and Linda Erikson's Motion to Consolidate Cases and to  
 3 Appoint Lead Plaintiffs and Lead Counsel. On August 13, 2007, Grucel was appointed lead  
 4 plaintiff.

5 The first amended complaint was filed October 11, 2007. Nominal defendant Extreme filed  
 6 a motion to dismiss on November 26, 2007. The parties agreed to a stipulation allowing Grucel to  
 7 file a second amended complaint by February 25, 2008, and the first motion to dismiss was vacated.  
 8 The SAC was filed on February 25, 2008. In the SAC, Grucel informs the court that he is no longer  
 9 able to "aggressively represent the interests of Extreme Networks in this case with energy,  
 10 enthusiasm and vigor," as he has disposed of his shares in Extreme. *See* SAC ¶ 36 n.7. In this same  
 11 footnote, the plaintiffs appear to be moving for permissive intervention under Fed. R. Civ. P. 24 of  
 12 Kathleen Wheatley, and moving to then substitute this new party as lead plaintiff. *Id.* ("plaintiffs  
 13 seek to substitute Kathleen Wheatley" who "is willing to intervene as plaintiff").

14 The SAC also makes reference to George Bennett, Jr. SAC ¶ 37. On February 20, 2008,  
 15 lead counsel filed a complaint on behalf of Bennett, Case No. 08-cv-01033-RMW. Five days later,  
 16 on February 25, lead counsel filed the SAC in the instant action naming Bennett as a party. SAC ¶  
 17 37. Lead counsel purported to notify the court that Bennett's case should be consolidated with the  
 18 instant action by including a footnote in the SAC. *Id.* ¶ 37 n.8. Lead counsel does not represent  
 19 plaintiffs Wu or Erikson. Plaintiffs Wu and Erikson are not mentioned in the SAC.<sup>4</sup>

## 20 II. ANALYSIS

21 Plaintiffs did not make a demand on the Extreme board before filing this suit. SAC ¶ 29.  
 22 Nominal defendant Extreme moves to dismiss because plaintiffs have not adequately alleged that  
 23 demand on the board would have been futile. Further, Grucel has disposed of his shares of stock in  
 24 Extreme. *Id.* ¶ 36 n.7. Extreme thus also moves to dismiss because Grucel no longer has standing to  
 25 maintain this action.

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26  
 27 <sup>4</sup> It appears that lead counsel, by filing an action on behalf of Bennett, are attempting to use the  
 28 consolidation procedure to add a plaintiff who is represented by them. As set forth below, the court  
 will require plaintiffs to move to appoint a new lead plaintiff and lead counsel.

1           **A. Grucel's Standing**

2           The Federal Rules of Civil Procedure require a shareholder bringing a derivative suit to have  
3 been a shareholder at the time of the challenged transaction and that the shareholder "fairly and  
4 adequately represent the interests of shareholders." Fed. R. Civ. P. 23.1. As discussed above,  
5 Grucel has sold his shares of stock in Extreme. The sale of his stock renders Grucel without  
6 standing to maintain this action. *Johnson v. Untied States*, 317 F.3d 1331, 1333-34 (Fed. Cir. 2003)  
7 ("when a plaintiff bringing an action on behalf of the corporation is the legal owner of the stock at  
8 the time of filing but does not maintain shareholder status throughout the course of litigation, the  
9 plaintiff no longer has standing to bring the action"). Although Grucel can no longer proceed with  
10 this action, another qualified shareholder can intervene on the grounds that their rights are no longer  
11 represented. *Malcolm v. Cities Serv. Co.*, 2 F.R.D. 405, 407 (D. Del. 1942). "The cause of action, if  
12 there be one, remains unaffected by the sale of the plaintiff's stock." *Id.*; see also *Pikor v. Cinerama*  
13 *Prod. Corp.*, 25 F.R.D. 92, 94-95 (S.D.N.Y. 1960). Grucel's lack of standing is fatal to the operative  
14 complaint, however, the presence of other plaintiffs as well as other shareholders seeking to  
15 intervene dictates that the dismissal be without prejudice. See *Pikor*, 25 F.R.D. at 95. The court  
16 expects that Grucel will withdraw from this action.

17           As discussed above, the second amended complaint indicates that Kathleen Wheatley seeks  
18 to intervene as lead plaintiff. SAC ¶ 36 n.7. Any party seeking permissive intervention must  
19 actually file a motion with the court and not simply insert their name into the complaint. See Fed. R.  
20 Civ. P. 24(b). A footnote in the complaint is not a substitute for following the rules of civil  
21 procedure. If Kathleen Wheatley seeks to intervene in this matter she may file a motion before the  
22 court. With Grucel's failure to adequately represent the shareholders and the potential addition of  
23 intervening plaintiffs, the court needs to carefully consider who would best represent the interests of  
24 Extreme. Accordingly, the parties should file new motions to appoint lead plaintiff and lead  
25 counsel, detailing why a chosen individual would be the best representative for the affected  
26 shareholders.

27           **B. Failure to Verify Complaint**

28           Rule 23.1(b) requires the complaint in a derivative action to be verified. The verification

1 requirement exists to prevent baseless strike suits. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363,  
2 371 (1966). Combined, Rule 11 and Rule 23.1 serve to assure the court "that some person, party,  
3 attorney, advisor, or otherwise has responsibly investigated the allegations at the behest of the  
4 named plaintiff, who then stands behind the merits of the complaint." *Rogosin v. Steadman*, 65  
5 F.R.D. 365, 367 (S.D.N.Y. 1974). An unverified derivative complaint should be dismissed with  
6 leave to amend. *See, e.g., Glenbrook Capital Ltd. Partnership v. Kuo*, 525 F. Supp. 2d 1130, 1146  
7 (N.D. Cal. 2007); Wright, Miller & Kane, Federal Practice and Procedure § 1827, at 57-58 (2d ed.  
8 1995); *but see McDonough v. Americom Int'l Corp.*, 151 F.R.D. 140, 143 (M.D. Fla. 1993)  
9 (declining to dismiss but requiring plaintiff to submit a verification within thirty days).

10 Rule 23.1(b)'s verification requirement has rarely been the subject of litigation, leaving many  
11 questions about its limits and what requirement it imposes above and beyond Rule 11's required  
12 reasonable investigation. *See generally* Wright, Miller & Kane, Federal Practice and Procedure §  
13 1827 (2d ed. 1995). Rule 23.1's requirement appears similar to that imposed on private securities  
14 plaintiffs under the Private Securities Litigation Reform Act. *Compare* Fed. R. Civ. P. 23.1 with 15  
15 U.S.C. § 77z-1(a)(2). The certification requirement for private securities class actions was imposed  
16 because Congress believed "that the plaintiff's bar had seized control of class action suits, bringing  
17 frivolous suits on behalf of only nominally interested plaintiffs in the hope of obtaining a quick  
18 settlement." *Greebel v. FTP Software, Inc.*, 939 F. Supp. 57, 58 (D. Mass. 1996). Congress hoped  
19 that requiring the investor to certify the complaint would "transfer[] control of the litigation from the  
20 attorneys to the investors." *In re USEC Securities Litigation*, 168 F. Supp. 2d 560, 564 (D. Md.  
21 2001).

22 Here, the second amended complaint has not been verified by anyone who is presently a  
23 party to this action, however, a "verification" was signed and submitted by Kathleen Wheatley, who,  
24 as discussed above, is not a party to the suit at this time. *See* SAC. The court has been unable to  
25 find any authority suggesting that a complaint can be verified by an individual who is not a party to  
26 the action. While Ms. Wheatley may at some point move to intervene in this action, she is not  
27 properly a plaintiff, much less the lead plaintiff, and cannot verify the complaint in this matter. The  
28 failure to verify is significant given the lead plaintiff's lack of standing and the apparent factual

1 errors in the complaint. In light of these intervening events, it is appropriate to insist on verification  
 2 by a proper party to the case to confirm that the plaintiff investors still wish to pursue this case.

3 **C. Demand Futility**

4 Delaware law requires a derivative plaintiff to first make a demand on the board of directors  
 5 to address the shareholder's concerns. *Ryan v. Gifford*, 918 A.2d 341, 351-52 (Del. Ch. Ct. 2007). If  
 6 the shareholder chooses not to make a demand, the shareholder must plead with particularity why  
 7 such a demand is excused. Fed. R. Civ. P. 23.1(b)(3)(B); *see, e.g., CNET Networks*, 483 F. Supp. 2d  
 8 947.

9 **1. Standards Governing Demand Futility**

10 Delaware law has two standards for excusing demand. *Compare Aronson v. Lewis*, 473 A.2d  
 11 805, 812 (Del. 1984) *with Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993). "Where the  
 12 challenged transaction was not a decision of the board upon which plaintiff must seek demand," the  
 13 *Rales* test applies. *See, e.g., Ryan*, 918 A.2d at 353. The *Rales* test requires the plaintiff to allege  
 14 particular facts that "create a reasonable doubt that, as of the time the complaint is filed, the board of  
 15 directors could have properly exercised its independent and disinterested business judgment in  
 16 responding to a demand." *Id.* at 353 (quoting *Rales*, 634 A.2d at 933-34).

17 Plaintiffs have made allegations challenging options granted between 1999 and 2006. While  
 18 the plaintiffs are entitled to inferences in their favor, those inferences must be reasonable ones.  
 19 Despite numerous deficiencies in the complaint, plaintiffs have alleged sufficient facts to raise a  
 20 reasonable inference that some backdating occurred between 1999 and 2003. Plaintiffs have not  
 21 alleged with specificity facts sufficient to raise a reasonable inference of backdating after 2003. The  
 22 board in place at the time Grucel filed suit was not the same as the board in place between 1999 and  
 23 2003. Accordingly, the court applies the *Rales* standard to decide whether demand is excused.  
 24 *Accord Desimone v. Barrows*, 924 A.2d 908, 927-28 (Del. Ch. Ct. 2007) (applying *Rales* where all  
 25 parties agreed it applied).

26 **2. Whether the Extreme Board is Disinterested and Independent**

27 To successfully plead demand futility, plaintiffs must demonstrate that there is a reasonable  
 28 doubt that a majority of the board of directors are not disinterested and independent. *Beam ex rel.*

1     *Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048-49 (Del. 2004). A director  
2 is presumed to be faithful to the corporation and able to objectively consider a demand. *Id.* at 1048.  
3 The plaintiffs must show, with particularity, why that presumption is overcome with respect to a  
4 majority of the board. *Id.* at 1048-49. Accordingly, plaintiffs must demonstrate that there is a  
5 reasonable doubt that at least four of the seven Extreme directors were not disinterested and  
6 independent. In determining whether plaintiffs have pled demand excuse, the court notes that an  
7 inquiry into a board's ability to consider a demand is context-dependent and fact-specific. *Id.* at  
8 1049-50; *see also Desimone*, 924 A.2d at 931 (suggesting a "cautious" and "non-generic" approach  
9 to considering challenges to options practices).

10       Accordingly, to plead demand futility plaintiffs must specifically allege facts that create a  
11 reasonable doubt that a majority of directors are disinterested and independent. A substantial risk of  
12 personal liability can create a reasonable doubt about a director's disinterestedness. *Wood v. Baum*,  
13 \_\_ A.2d \_\_, 2008 WL 2600981 at \*2 (Del. 2008). However, when directors are exculpated from  
14 liability for certain conduct, the plaintiff must plead particularized facts alleging a non-exculpated  
15 claim against the directors. *Id.* at \*3. If directors are exculpated except for claims based on  
16 "'fraudulent,' 'illegal' or 'bad faith' conduct," then "a plaintiff must also plead particularized facts that  
17 demonstrate that the directors acted with scienter, *i.e.*, that they had 'actual or constructive  
18 knowledge' that their conduct was legally improper." *Id.*

19       In *Wood*, the Delaware Supreme Court upheld the dismissal of a complaint by the Court of  
20 Chancery for failure to excuse demand. *Id.* at \*4. Municipal Mortgage and Equity is a LLC with a  
21 ten-member board of directors. *Id.* at \*1. The operating agreement exempts directors from any  
22 liability "except in the case of fraudulent or illegal conduct of such person." *Id.* The complaint  
23 alleged "many violations of federal securities and tax laws but [did] not plead with particularity the  
24 specific conduct in which each defendant 'knowingly' engaged." *Id.* at \*3. When asked to identify  
25 particularized facts that would establish actual or constructive knowledge, the plaintiff identified  
26 facts falling into "four main categories: (a) the defendants executed MME's annual reports and other  
27 publicly filed financial reports; (b) the defendants authorized certain transactions; (c) five of the  
28 defendants served on MME's Audit Committee; and (d) other 'red flags'." *Id.* None of the alleged

1 facts were sufficient to demonstrate actual or constructive knowledge. *Id.* Specifically, neither the  
 2 execution of financial reports by directors nor membership on a committee is sufficient to establish  
 3 scienter. *Id.* at \*3-\*4.

4 Paragraph 201 comprises plaintiffs' allegations regarding demand futility. At the time suit  
 5 was filed, Extreme's board of directors consisted of Mark Canepa, Gordon L. Stitt, W. Michael  
 6 West, Harry Silverglide, Robert L. Corey, Kenneth Levy and Charles P. Carinalli. SAC ¶ 201.  
 7 Plaintiffs make no allegations against director Canepa. *See id.* The complaint has boilerplate  
 8 allegations against all of the directors except Canepa consisting of knowledge of backdating based  
 9 on committee service, issuance of false financial statements and administration of stock option  
 10 grants. *Id.* The complaint alleges that Stitt, Carinalli, Silverglide and Levy are interested through  
 11 the receipt of backdated stock option grants. *Id.* Additionally, the complaint alleges that Stitt,  
 12 Carinalli and Silverglide participated in insider trading. *Id.*

13                           **a.     Backdated Stock Option Grants**

14 Plaintiffs do not contend that three of the directors, West, Corey and Canepa, are interested  
 15 by virtue of receiving backdated options. Plaintiffs allege, however, that Stitt, Carinalli, Silverglide  
 16 and Levy are interested because they received backdated stock option grants. SAC ¶ 201. These  
 17 alleged backdated options were granted on five separate occasions. *Id.* ¶ 116. However, there are  
 18 factual errors in the complaint for three of these five occasions. *See* option chart *supra* (July 5,  
 19 2000; April 9, 2001; Oct. 22, 2001).

20 Moreover, the one and only questioned grant to Levy does not appear to suggest backdating.  
 21 The grant to Levy on October 22, 2001 was not even in the lower third of prices for that month. The  
 22 challenged grant was reported to the SEC within eight business days on a Form 3. SAC ¶ 109. A  
 23 Form 3 filing is an initial statement of ownership of a beneficial security. *See* 17 C.F.R.  
 24 §240.16a-3(a). The Form 3 was timely filed; the deadline for reporting an initial director grant is ten  
 25 days. 15 U.S.C. 78p(a)(2)(B). Levy joined the board in October 2001, SAC ¶ 47, and so the fact  
 26 that the option grant was reported on a Form 3 that same month suggests that the grant coincided  
 27 with Levy becoming a director. These facts alone do not raise a reasonable inference that this grant  
 28 was backdated. *See In re CNET Networks, Inc.*, 483 F. Supp. 2d 947, 960 (N.D. Cal. 2007) ("Mere

1 reliance on the numbers is not sufficient when plaintiffs are confronted with a legitimate,  
2 judicially-noticeable explanation for the grant date. To plead with particularity that this grant was  
3 backdated, plaintiffs would need to allege specific facts showing that this was not the true grant  
4 date."); *accord In re Zoran Corp.*, 511 F. Supp. 2d 986, 1007 (N.D. Cal. 2007) ("The bottom line is  
5 that this grant seems to have been nothing more than the formulaic grant made to all directors upon  
6 joining the board. Backdating is not indicated.").

7 Additionally, none of these options were ever exercised by any of the directors and, at most,  
8 only one grant remains outstanding because the others were cancelled or surrendered. Decl. of  
9 Joseph E. Floren, Ex. 2 at 54 (Extreme's Form 10-K filed June 28, 2007). Plaintiffs have not  
10 pleaded any facts that would suggest that the directors received a benefit in exchange for the  
11 cancellation or surrender of their options.

12 The Delaware Chancery Court has held that accepting backdated stock options creates a  
13 reason to doubt a director's disinterestedness sufficient to disqualify him or her from being able to  
14 consider a demand. *Ryan*, 918 A.2d at 356. This court has suggested, however, that a director who  
15 no longer stands to benefit from backdated options may no longer be disqualified from considering a  
16 demand. *See CNET*, 483 F. Supp. 2d at 962. Here, the directors appear to have lost any apparently  
17 backdated stock options prior to the special committee report. Whether they were divested of any  
18 challenged options before suit was filed is unclear from the pleadings. It is therefore a close call as  
19 to directors Stitt, Carinalli, and Silverglide. It would be inappropriate, however, to disqualify Levy  
20 from considering a demand on the board regarding backdating as the plaintiffs have not pleaded  
21 facts sufficient to raise a reasonable inference that he is interested. Accordingly, even if directors  
22 Stitt, Carinalli and Silverglide all held backdated options when suit was filed, the plaintiffs have  
23 failed to establish that a majority of directors are interested due to holding backdated options.

24                           **b. Committee Membership, Filing of Statements and Administering  
25 Stock Option Grants**

26 The complaint alleges that all of the directors with the exception of Canepa should be  
27 disqualified from considering a demand on the board because they served on either the  
28 Compensation or Audit Committees, they filed false financial statements or were responsible for

1 administering stock option grants. SAC ¶ 201. While plaintiffs do not address these allegations in  
2 their brief, they are made in the complaint to excuse demand failure.

3 "Delaware law on this point is clear: board approval of a transaction, even one that later  
4 proves to be improper, without more, is an insufficient basis to infer culpable knowledge or bad faith  
5 on the part of individual directors." *Wood*, 2008 WL 2600981 at \*3. The Delaware Supreme Court  
6 has also made clear that a director's execution of financial reports, without more, is insufficient to  
7 create an inference that he had actual or constructive notice of any illegality. *Id.* at \*3. The  
8 complaint's boilerplate allegations without particularized facts as to knowledge or intent on the part  
9 of any directors cannot overcome this. Demand excuse requires particularized facts.

10 Plaintiffs have not alleged any facts establishing culpable knowledge or bad faith, and  
11 therefore cannot raise a reasonable doubt as to disinterestedness. Consequently, they cannot show  
12 that a majority of the directors are not disinterested or independent and so the complaint must be  
13 dismissed.

14 **c. Insider Trading**

15 Plaintiffs allege that directors Stitt, Silverglide and Levy participated in insider trading by  
16 selling thousands of shares of stock based on knowledge of material non-public information. SAC  
17 ¶¶ 19, 39, 45, 48, 201, 204, 267-71. The complaint specifies the proceeds received from the sales  
18 and a range of dates in which the sales took place. *Id.* ¶ 19. It does not set forth any other details.

19 "[I]t is unwise to formulate a common law rule that makes a director 'interested' whenever a  
20 derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time  
21 when he possessed material, non-public information." *Guttmann v. Huang*, 823 A.2d 492, 502 (Del.  
22 Ch. Ct. 2003). In *Guttmann*, Vice Chancellor Strine examined the details surrounding stock sales by  
23 directors of NVIDIA and concluded that the plaintiffs had not pleaded sufficient facts to excuse a  
24 demand on the board. *Id.* at 503-4. Specifically, Vice Chancellor Strine looked not at the dollar  
25 proceeds but the pattern of trading, whether the directors' trading habits had changed year over year  
26 and whether the directors had divested themselves of large percentages of their total ownership. *Id.*  
27 accord *In re Silicon Graphics Inc.*, 183 F.3d 970, 986 (9th Cir. 1999) (whether insider trading is  
28

1 suspicious depends upon: "(1) the amount and percentage of shares sold by insiders; (2) the timing  
2 of the sales; and (3) whether the sales were consistent with the insider's prior trading history").

3 Plaintiffs have provided no particularized facts from which a reasonable inference of  
4 wrongdoing can be drawn. The complaint details only date ranges spanning as much as six years  
5 and dollar amounts of realized proceeds. It does not detail the percentage of the holdings sold by  
6 Carinalli, Silverglide and Stitt. It does not detail their past trading history, the timing of the sales or  
7 whether the pattern of trading is suspicious. It is a mere cursory allegation. Therefore, it would be  
8 inappropriate to disqualify any directors from considering a demand based on these allegations.

9 **D. Leave to Amend**

10 Plaintiffs have not pleaded facts sufficient to show that a majority of the board in place when  
11 the action was commenced are not disinterested or independent and so have not excused the failure  
12 to make a demand. Based on the allegations and judicially noticeable SEC filings, none of the  
13 directors appear to have received an improper benefit from an allegedly backdated option grant.  
14 Plaintiffs have failed to allege with particularity any facts from which it could be inferred that  
15 particular directors knew or should have known of accounting improprieties and any facts  
16 suggesting that the board knowingly allowed or participated in a violation of law. Finally, the  
17 plaintiffs have failed to allege any facts suggesting that the sale of stock by directors was improper.  
18 In any event, even when backdating is "almost certain," the complaint must be dismissed unless it  
19 provides adequate detail regarding the knowledge and roles of the defendants. *In re Atmel Corp.*,  
20 2007 WL 2070299 at \*6 (N.D. Cal. 2007).

21 Grucel also lacks standing to continue this action. However, Grucel's inability to plead facts  
22 sufficient to excuse demand should not prejudice the shareholders he is no longer qualified to  
23 represent. Consequently, the court grants leave to plaintiffs to move to appoint a new lead plaintiff  
24 and counsel and to file an amended complaint.

25  
26  
27  
28

### III. ORDER

2 For the foregoing reasons, the court GRANTS Extreme's motion to dismiss. Plaintiffs have  
3 twenty days to move to appoint lead plaintiff and lead counsel and file an amended complaint.

5 DATED: 8/11/08

Ronald M Whyte

RONALD M. WHYTE  
United States District Judge

# **United States District Court**

For the Northern District of California

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11 Counsel are responsible for distributing copies of this document to co-counsel that have not  
12 registered for e-filing under the court's CM/ECF program.

13 **Dated:** 8/12/08

14 /s/ MAG  
**Chambers of Judge Whyte**